



Ashoka Centre for
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ABSTRACT

A new consensus on fiscal policy has emerged in advanced economies, that stimulus is both needed and feasible. At first blush, the scope for stimulus seems even greater in emerging markets, since their primary deficits are smaller and interest-growth differentials more favorable, suggesting that they can sustain much higher levels of debt. But more careful analysis suggests that this is not the case. The authors point out that what matters for debt sustainability are not current conditions but rather the range of possible future outcomes. And prospects for interest rates and growth are more uncertain in emerging markets, while primary balances are more difficult to adjust. As a result, debt limits are in fact tighter than advanced economies. Taking India as a case study, the authors argue that what is needed in the current situation is responsible, slow fiscal adjustment. More generally, one should be careful about importing wholesale the new fiscal consensus into emerging markets.

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1. Introduction

There is now a new consensus on fiscal policy in advanced economies (AEs). But how well will this consensus travel? Is this a case where policymakers in emerging markets (EMs) should take their cues from their AE counterparts? To address this question, the Ashoka Center for Economic Policy (ACEP) hosted an exchange amongst the authors; this brief is the result.

The new consensus can be summarized in three propositions. First, macro policy measures are needed to increase aggregate demand to match supply, because private sector demand has been chronically weak. Second, fiscal policy needs to be the main macro tool to close the output gap, since monetary policy tools have largely been exhausted. Third, there is room to use fiscal policy in this way, because government debt, even though it is high, appears to be sustainable.

These propositions have been increasingly embraced by economists and policymakers, both in the United States and in Europe. Consequently, they could well become the template for advanced economies (AEs) as they attempt to restore their Covid-damaged economies.

Underlying the consensus is a set of assumptions and arguments, which will obviously apply somewhat differently in emerging markets. The question is whether these differences are material enough to affect the broad policy conclusions.

2. Unpacking the Consensus

We unpack the arguments underlying the new consensus into three questions about the potential differences between AEs and EMs:

1. Is the macro-economic situation the same?
2. Is there more uncertainty about primary balances?
3. Is there more uncertainty about the interest-growth differential?

To preview our conclusions, our answers are no, yes, and yes. This leads us to have a more cautious message for EMs than for AEs.

We focus here on one major EM, India, because it is the country we know better. But we also consider relevant data on four other major EMs, from Latin America (Brazil), East Asia (Indonesia), sub-Saharan Africa (South Africa), and Europe (Turkey). Although each one is different, the broad conclusions we draw for India seem to apply to other EMs as well.

1. Is the macroeconomic situation the same?

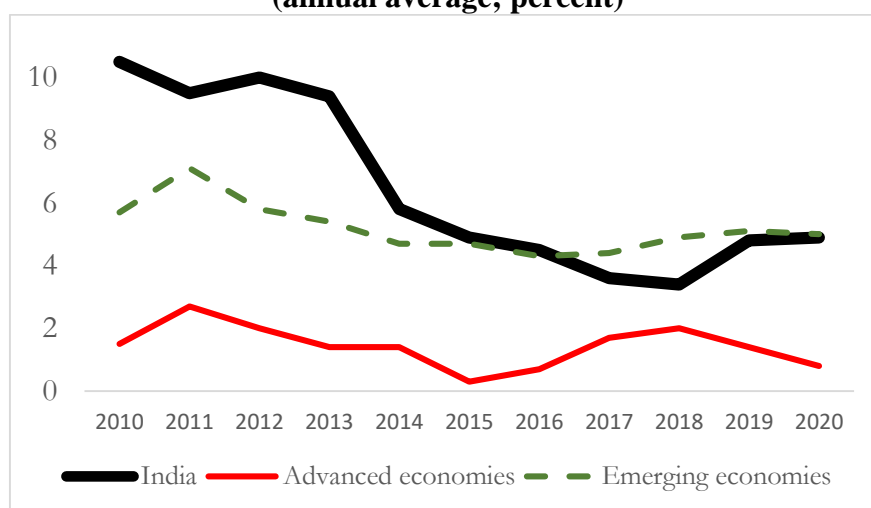
The case for policy activism is driven by a diagnosis that AEs are suffering from secular stagnation, where aggregate demand is inadequate to match potential capacity at any positive interest rate. The diagnosis in EMs, however, is different. In India, for example, the slowdown of trend growth is the result of supply-side problems, most notably a debilitated corporate sector and a seriously

¹The exchange itself can be found here: https://www.youtube.com/watch?v=RM_QXhBLwQ4.

impaired financial system, which have held back investment and exports for almost a decade (Subramanian and Felman 2019). Weak demand is not a major issue.

This macro difference is mirrored in the divergent trends of AE and EM inflation. Figure 1 shows that in AEs the sustained shortfall in aggregate demand has pushed inflation well below the 2 percent rate targeted by central banks. In contrast, in EMs, more robust demand has kept inflation running at much higher levels. In India, inflation has averaged 5 percent over the past decade, exceeding the 4 percent central rate targeted by the country's monetary regime.

Figure 1. Inflation in India, other emerging economies, and advanced economies, 2010–20 (annual average; percent)



Source: International Monetary Fund, *World Economic Outlook*.

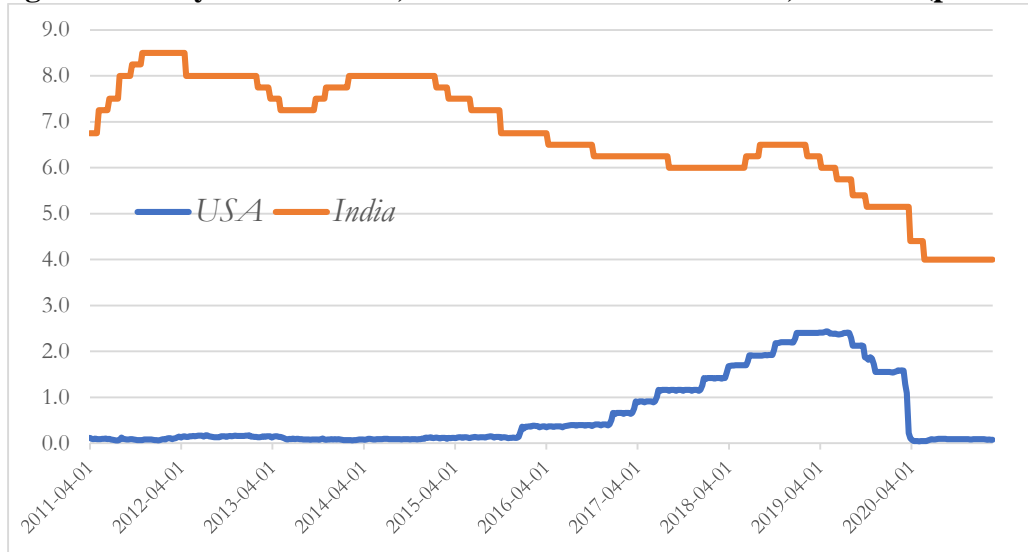
In the effort to bring inflation back to target, AE central banks have largely depleted their toolkit, bringing interest rates down to near zero. The situation in EMs is quite different, for two reasons. First, the equilibrium real interest rate, r^* , is typically higher than in advanced countries. And second, inflation is typically and significantly higher than in AEs. As a result, nominal policy rates in major EMs are significantly positive, giving central banks substantial room to ease before they would be constrained by the zero lower bound.

For example, India's nominal policy rate is 4 percent, even after historically large reductions at the onset of the Covid crisis (figure 2). The Reserve Bank consequently has room to take further action, which may not even be needed, since forecasts are optimistic about the nascent recovery, with the International Monetary Fund (IMF) forecasting GDP to rebound by more than 11 percent this year.²

With a different macro situation and toolkit, the need for fiscal activism in India is consequently smaller than in AEs. But what about the *scope* for such policy?

² See IMF World Economic Outlook Update January 2021, <https://www.imf.org/en/Publications/WEO/Issues/2021/01/26/2021-world-economic-outlook-update>

Figure 2. Policy interest rates, India and the United States, 2011–20 (percent)



Sources: St. Louis Fed's FRED and IMF.

The claim that there is scope for activist fiscal policy in AEs derives from some fiscal arithmetic. Governments need to ensure that they do not accumulate too much debt because then they will lose the confidence of financial markets and will no longer be able to borrow. Arithmetically, the debt ratio they can in principle sustain is governed by the following equations:

$$d_t = (1 + r)/(1 + g) d_{t-1} - s \quad (1)$$

$$d_t = d_{t-1} \Rightarrow s = (r - g)/(1 + g) d \quad (2)$$

where d_t and d_{t-1} are the debt-to-GDP ratios in time periods t and $t - 1$, respectively; r and g are real interest and growth rates, respectively; and s is the primary balance as a percent of GDP.³

These equations imply that debt sustainability requires the primary balance to be sufficient to cover the debt service. If the rate of interest, r , is higher than the rate of economic growth, g , the primary balance, s , needs to be positive, meaning the country needs to run a primary surplus. But if $r - g$ is negative, countries can run a primary deficit (negative s) while keeping the debt ratio constant.⁴

Table 1 summarizes the situation in the United States and major emerging markets (excluding China, which is sui generis). It is readily apparent that over the past decade the EMs have run much smaller primary deficits than the United States. In fact, Brazil, Indonesia, and Turkey have essentially not run any deficits at all, keeping their primary accounts close to balance.

³ The primary balance is government revenue less noninterest expenditure.

⁴ Strictly speaking, r refers to the average cost of borrowing rather than the interest rate. In our analysis of India, the two are close enough to each other not to make a difference to our analysis. Throughout, we calculate $r - g$ in terms of their respective nominal magnitudes.

At the same time, EM interest-growth differentials have been even more negative than in the United States, with the notable exception of South Africa, where the differential has been positive, at 1.2 percentage points.

Table 1. Key fiscal variables: Average, 2010–19		
<i>Country</i>	<i>Primary balance</i>	<i>Interest- Growth differential</i>
Brazil	−0.2	−2.0
India	−2.8	−4.6
Indonesia	−0.5	−3.5
South Africa	−1.4	1.2
Turkey	−0.3	−4.5
United States	−4.1	−1.6

Primary balance in percent of GDP; interest-growth differential in percentage points.

Sources: IMF, Reserve Bank of India (RBI), FRED, World Bank, World Development Indicators (WDI) and Haver.

At first blush, then, it seems as if the consensus from advanced economies does indeed carry over into emerging markets. Indeed, with smaller primary deficits and more negative interest-growth differentials EMs might seem to have much more space for fiscal stimulus than advanced economies. But first impressions can be misleading. What the table shows is the past, whereas what matters for considering the current fiscal space is the range of possible future outcomes. And when we shift our focus from first moments (means) to second moments (standard deviation about the mean), a different picture emerges.

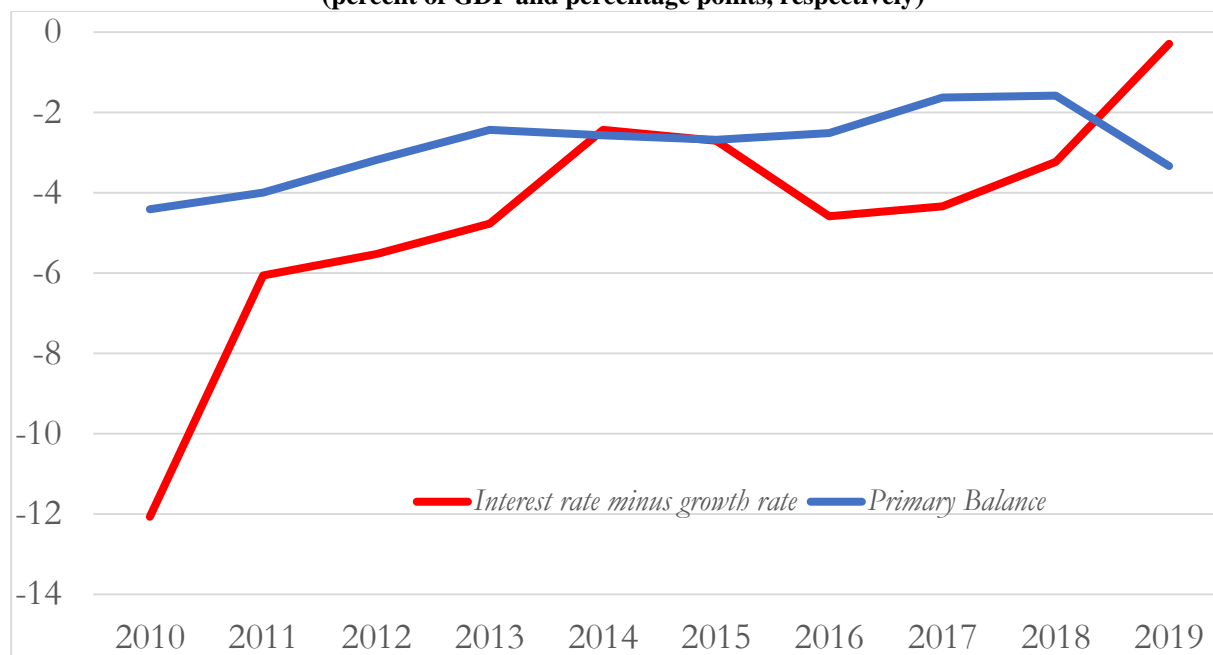
2. *How much uncertainty about primary balances?*

To operationalize the fiscal equations and deduce the room for fiscal expansion, one needs to forecast primary balances and interest-growth differentials. Projections are uncertain, so caution is warranted, especially when trying to assess whether a particular debt level is safe or not. And the level of uncertainty is very different in AEs and EMs, partly because of larger genuine uncertainty, partly because of doubts about the ability and commitment of governments to adjust if things go wrong. Indeed, there is even uncertainty about the actual numbers themselves, for example about the true level of primary balances in the past.

Consider India as a case in point. Figure 3 shows that, according to the IMF, the country has run a modest primary deficit over the past decade of around 2 percent of GDP, which should have been far outweighed by an exceptionally favorable interest-growth differential, averaging minus 4½

percent.⁵ Using equation (1) to trace the evolution since 2011, the debt ratio should have fallen by a cumulative 4 percentage points of GDP.

Figure 3. India: Primary balance and interest-growth differential ($r - g$), 2010–19
(percent of GDP and percentage points, respectively)



Sources: IMF, RBI, and WDI.

In fact, India's debt-to-GDP ratio has actually *increased* over this period, by around 4 percentage points of GDP, as figure 4 shows. The reason is that every year contingent liabilities added nearly 1 percentage point of GDP on average to the debt stock (the residual in figure 4, in red).⁶ These liabilities materialized because time and again the government had to rescue troubled state-run entities: It had to assume the debts of financially weak firms such as Air India and the electricity distribution companies, and it needed to recapitalize the public sector banks in the wake of their nonperforming asset (NPA) problem.

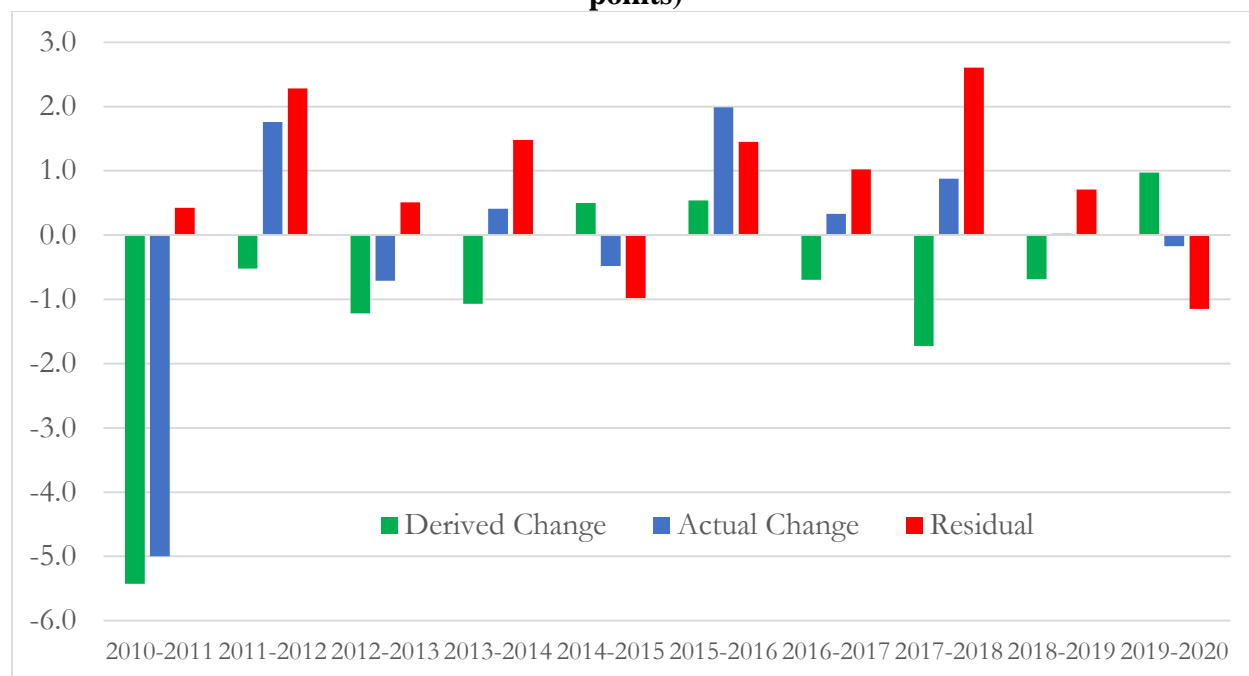
The broad picture of recurrent contingent liabilities is common across emerging markets, even if the details vary from country to country. So, the first lesson is this: in EMs, official measures understate the true primary deficits. To get a true measure of debt prospects, one also needs to consider the contingent liabilities likely to be realized in coming years.

⁵ IMF primary deficits are somewhat larger than the official numbers for India because they exclude privatization receipts from revenue. The interest-growth differential is calculated as the difference between interest rates on 10-year government bonds and nominal GDP growth rates.

⁶ The difference between the actual and derived changes in debt stems from (a) the realization of contingent liabilities (in which the government assumes the debts of other entities); (b) differences between the market interest rate on government bonds and the effective interest rate on overall government debt; and (c) valuation effects on foreign currency-denominated debt. In India, only the first factor is material. On average, the government assumes about 1 percentage point of GDP in debt per year.

This is a difficult task, which inevitably injects substantial uncertainty into fiscal projections, especially in the current circumstances, where the pandemic has placed public enterprises under considerable financial stress. In India, for example, NPAs are estimated by the central bank to almost double in the coming year, from 7.5 percent to 13.5 percent, in which case the public sector banks will need to be recapitalized again. So, it seems likely that the pace at which contingent liabilities are realized will increase from the historical rate of about 1 percentage point of GDP per year. But by how much? It is difficult to say.

Figure 4. India: Actual and derived change in debt, and residual, 2010–20 (percentage points)



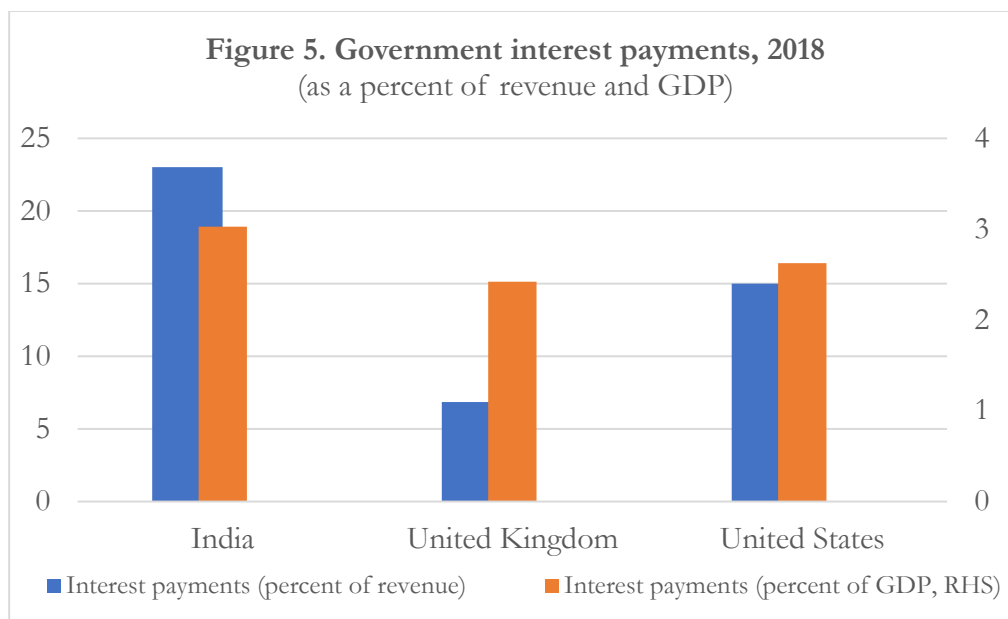
Source: Authors' calculations based on RBI and WDI data.

Given these uncertainties, it might be worth coming at the matter from a different direction. Instead of trying to predict primary balances, consider instead what would happen if the interest-growth differential turned positive and sustainability concerns arose. In that case, countries would need to start running primary surpluses. That is, they would need to increase taxes and/or reduce noninterest expenses. How politically difficult would that be?

In the AEs, the primary balance could likely be increased by significant amounts. One reason is that the share of interest payments remains reasonably low, as a ratio of GDP and even more importantly as a share of the budget (figure 5) (Blanchard 2019, Furman and Summers 2020). Consequently, there is a large noninterest spending base, which can be compressed if needed. In addition, taxes can always be increased.

But in EMs the primary balance is politically more difficult to adjust. The size of government tends to be much smaller than in AEs, so an equivalent adjustment in terms of GDP requires a much larger percentage change in taxes or spending. The problem on the spending side is particularly acute, since a large portion of expenditures is taken up by interest payments, so that the basis for

any spending cuts is particularly small. In India, interest payments absorb one-fifth of government revenues, much more than in AEs (figure 5).⁷ With so much of the budget going for interest, reducing central government spending by 1 percentage point of GDP would require a 5 percent reduction in noninterest expenditure, 2½ times as much as in France.⁸



Source: WDI.

Perhaps because fiscal adjustments are so politically difficult, the primary balance has proved remarkably stable in India and indeed in most emerging markets over the past decade, notwithstanding the authorities’ repeated plans (set forth in numerous fiscal responsibility plans and targets) to strengthen the fiscal position. Table 2 shows that the standard deviation of the primary balance has been much smaller in EMs than in the United States, with only Brazil and Turkey showing any significant amount of flexibility. (To grasp this visually, examine the data for India in figure 3.)

⁷ And this was before the debt accumulated during the Covid crisis, which will add more than half of 1 percentage point to India’s government interest-GDP ratio.

⁸ Noninterest expenditure accounts for 20 percent of GDP in India and 53 percent in France (World Development Indicators).

Table 2. Primary balance: Standard deviation, (percent of GDP)	2010–19
Brazil	1.9
India	0.9
Indonesia	0.6
South Africa	0.7
Turkey	1.7
United States	2.5

Source: IMF.

Of course, during this period there was very little market pressure; should debt sustainability concerns materialize, the government could clearly make some adjustment. But how much? It is far from clear.

3. *How much uncertainty in $r - g$?*

In addition to the uncertainty regarding the primary balance, there is uncertainty about the interest-growth differential, and this uncertainty is substantially larger for EMs than for AEs.

Over the past decade, this differential has tended to be favorable in EMs, indeed much more negative than in AEs, because average growth has been much higher while average interest rates have been closer to those in advanced countries. But past trends are no guarantee of future performance—especially because seemingly comfortable past averages conceal a considerable variation in $r - g$ over time.

Table 3 shows that the variation of $r - g$ has indeed been small in the United States over the past decade. But in emerging markets it has often been an order of magnitude larger.

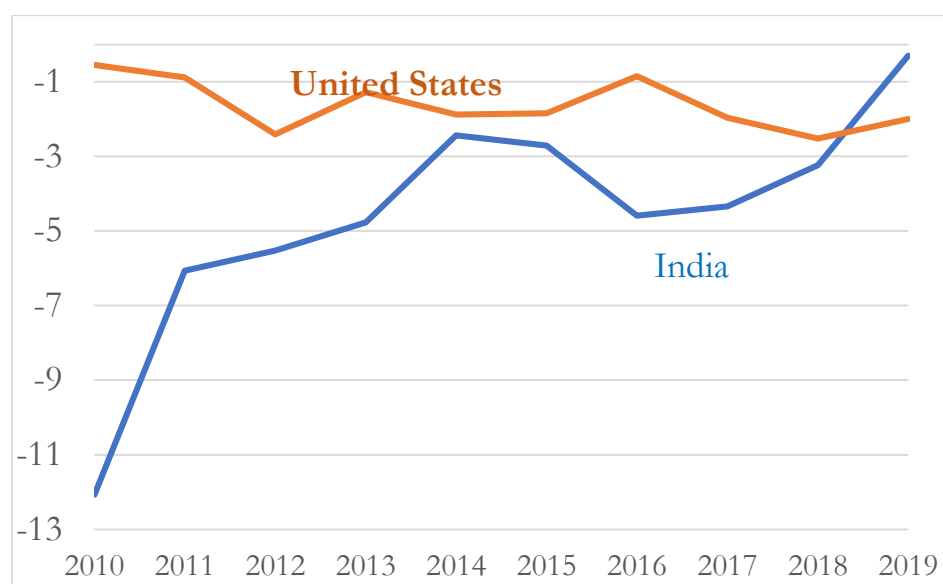
Table 3. Interest-growth differential: Standard deviation, 2010–19 (percentage points)	
Brazil	4.7
India	3.1
Indonesia	4.3
South Africa	2.2
Turkey	3.7
United States	0.7

Sources: IMF, RBI, FRED, and Haver.

In India, partly as a result of a sharp deceleration in nominal GDP growth, $r - g$ shrank from 12 percent a decade ago to around zero (figure 6). And this was during a relatively tranquil period.

During periods of financial stress, the volatility in $r - g$ is even greater. And these stressful periods arise frequently, since EM governments have less credibility and their economies have more vulnerabilities than AEs. They have shallower financial markets and greater financial system fragilities. They have more debt in foreign currency, which makes the value of the debt more vulnerable to exchange rate movements. They also have a more flighty investor base, which makes them more vulnerable to “sudden stops” and large increases in risk premia.

Figure 6. Interest-growth differential, India and United States, 2010–19 (percentage points)

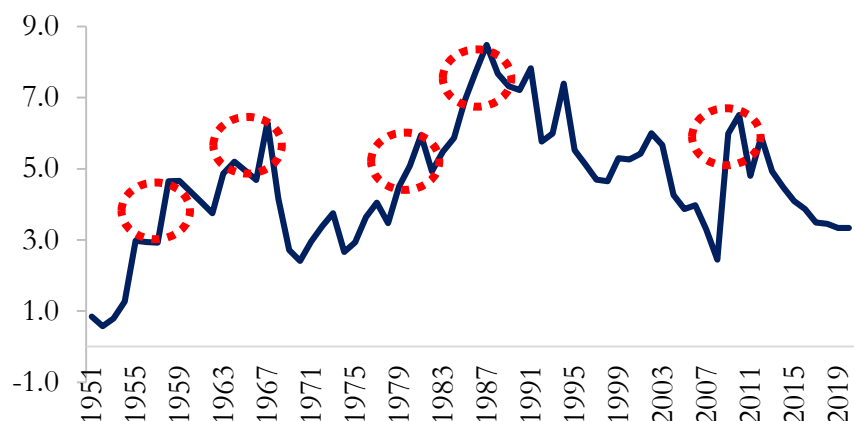


Sources: Haver and WDI.

Bouts of investor flight are often triggered by increases in fiscal deficits. In large part, this happens because the many vulnerabilities of EMs are inevitably reflected in the budget, as governments step in to bail out the sectors that have come under severe stress. And when this occurs, when deficits suddenly soar, the adjustment difficulties come into play, causing markets to worry that the deterioration could persist for a very long time. For these reasons, every major Indian financial-cum-economic crisis (in 1958, 1966, 1979, 1991, and 2013) has been accompanied and/or preceded by large increases in the fiscal deficit, as figure 7 shows.

The lesson is clear: in EMs just as in AEs, one must take into account the degree of uncertainty about primary deficits and interest-growth differentials. This degree of uncertainty is higher in EMs than in AEs.

Figure 7. Fiscal deficits (blue line) and financial crises (red circles), 1951–2019



Source: RBI; Deficit relates to the central government.

III. Putting It Together: An Illustrative Calculation

Let us go back to the basic fiscal debt sustainability equations (1) and (2) above. Further simplifying (since $1 + g$ is close enough to 1), equation (2) yields an equation for the primary balance needed to maintain a constant debt ratio:

$$s = (r - g) d \quad (3)$$

In AEs, for the time being $r < g$, so governments can run primary deficits. Take a typical AE and assume:

- $r = -1$ percent
- $g = 2$ percent
- $d = 100$ percent

If these values were to continue forever, the country could afford a primary deficit of 3 percent of GDP and keep the debt ratio constant.

Now take into account uncertainty. The interest rate r might well increase and the growth rate g might well decrease in the future. Thus, the typical AE will have to be prudent. Suppose that reasonable bounds are that, for the foreseeable future (say the next 10 years, as it is difficult to make predictions beyond that), the real interest rate will likely not exceed 2 percent and the growth rate will likely be no less than 1 percent. Were this worst case to happen, $r - g$ would be 1 percent, implying that to ensure sustainability the country would need to generate a primary surplus of 1 percent of GDP. Assuming a ratio of government spending to GDP of 40 percent, the country would have to generate a primary surplus equal to 2.5 percent of its budget. This may be tough, but may well be achievable.

Now, consider the same equation for EMs, and suppose the relevant values today are the following:

- $r = -1$ percent

- $g = 4$ percent
- $d = 100$ percent

If these values were to continue, the country could afford a primary deficit of 5 percent of GDP, so just looking at first moments, this EM country seems to have more fiscal space than the corresponding AE.

This however ignores uncertainty and the size of the required adjustment relative to the size of the budget. Suppose that reasonable bounds are that, for the foreseeable future, the interest rate will likely not exceed 4 percent and the growth rate will likely be no less than 1 percent. Were this worst case to happen, $r - g$ would be 3 percent and the country would need to generate a primary surplus of 3 percent of GDP. Assume that the ratio of government spending to GDP is only 20 percent. Then the country would have to generate a primary surplus equal to 15 percent of its budget. For the reasons we discussed earlier, this is unlikely to be achievable.

Put another way, if the maximum feasible primary surplus is 2 percent of GDP, while the interest rate–growth differential could reach 3 percent, then the maximum sustainable debt ratio is 67 percent of GDP.

Two factors might allow for higher sustainable debt ratios, and would have to be taken into account in a more careful computation. A longer maturity of debt would imply a slower increase in the interest paid on debt, and thus more time to adjust. And to the extent that the increase in rates reflected a bout of adverse animal spirits of foreign investors, access to outside liquidity would help cushion the increase or even eliminate it in the first place by convincing investors not to speculate against the country. Both factors suggest the desirability of preventive policy actions, both to increase the maturity of the debt and to enter liquidity agreements with the IMF. Neither will eliminate uncertainty, but both will help and allow for a somewhat higher sustainable level of debt.

What does this exercise imply for India?

Debt is high, having increased (because of Covid) by around 20 percentage points during the past year to more than 90 percent of GDP. And even if the historically favorable interest-growth differentials continue, debt might nonetheless continue to increase, since the reported primary deficit has widened to a sizable 5 percent of GDP.⁹

Moreover, the favorable interest-growth differentials may not continue. Even before Covid, $r - g$ had essentially shrunk to zero, as real growth had gradually slowed over the past decade, to just 4.2 percent in 2019–20. It is possible that long-term growth will speed up to its previous potential, restoring differentials to their historical levels. But it is also possible that potential growth may have been damaged by the corporate, banking, and labor market scars from the pandemic, in which case $r - g$ may be less favorable than in the past.

⁹ Over the next year, the projected large rebound in the economy will reduce the debt ratio by increasing the denominator (GDP). But after that the ratio could resume its rise unless the primary deficits are reduced significantly.

Should $r - g$ turn unfavorable, how easy would it be for India to adjust? Assuming that next fiscal year the government manages to get the reported primary deficit back to around 2 percent of GDP as the pandemic recedes, and realized contingent liabilities are somehow contained at their historical level (1 percent of GDP), the effective primary deficit would amount to 3 percent of GDP. Suppose for the sake of argument that $r - g$ turned out positive, equal to 1 percent, so that debt stabilization required a primary surplus of around 1 percent and thus an adjustment of the primary balance of 4 percentage points of GDP. Even if markets allowed this adjustment to be spread out over several years (during which debt would continue to increase), it might still be very difficult to achieve—it would be twice as large as the fiscal consolidation accomplished after the historic crisis of 1991.¹⁰

India consequently faces a choice. It could maintain its sizable primary deficits, counting on favorable interest-growth differentials to contain the growth in its debt. But this strategy runs a serious risk. Without a coherent debt path, investors could at some point become worried about fiscal prospects, demanding a large risk premium for holding government securities. In that case, the fiscal arithmetic could suddenly turn grim. Without much scope to adjust the primary balance in the short run, India could quickly find itself trapped in a vicious cycle of rising interest rates leading to rising debt, validating investor fears and leading to further increases in interest rates.

Alternatively, India could embark on a medium-term strategy of winding back its primary deficits, as proposed in the dissent note to the 2017 Fiscal Responsibility and Budget Management Review Committee (Subramanian 2017). This adjustment would need to be gradual, so that it doesn't undermine the incipient recovery from last year's deep Covid-induced recession. A gradual adjustment would also be more politically achievable, hence more credible to investors. Indeed, as the fiscal consolidation proceeds, India could enter a virtuous cycle, in which achieving the targets improves credibility, resulting in lower risk premia, more favorable $r - g$, and thereby a swifter reduction in debt.

The choice seems clear: What India needs is responsible, slow fiscal adjustment.

Summing up: There is no question that favorable interest-growth differentials make any public debt situation less worrisome, for both advanced economies and emerging markets. But there are still limits to how high debt can go, and these limits are tighter in EMs. Prospects for growth and interest rates are more uncertain. The scope for fiscal adjustment in the face of higher rates or lower growth is more limited. Consequently, one should be careful in importing wholesale the new fiscal consensus from advanced economies to emerging market countries, including India.

¹⁰ The fiscal improvement during the mid-2000s reflected soaring revenues from an unprecedented economic boom, rather than any tax or spending measures.

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